United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510–6075

April 23, 2007

The Honorable Ben Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Chairman Bernanke:

The Senate Committee on Banking, Housing, and Urban Affairs has held two hearings this year on the problems in the subprime mortgage market, particularly problems created by predatory and abusive lending. A number of Committee members raised concerns at the hearings that the regulators have not kept pace with deteriorating credit standards or the growth of abusive, unfair and deceptive lending practices. In addition, we are concerned that the Federal Reserve Board has not exercised its obligations under the Home Ownership and Equity Protection Act (HOEPA) of 1994 to issue regulations that address the problems of predatory lending. Specifically, HOEPA states:

> The Board, by regulation or order, shall prohibit acts or practices in connection with (A) mortgage loans the that the Board finds to be unfair, deceptive or designed to evade the provisions of the sections; and (B) refinancing or mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.

We note that the statute does not simply grant authority to be used at the discretion of the Board. The law clearly mandates action by the Federal Reserve Board. Action by the Board pursuant to this statute is crucial because such a regulation would apply both to bank and non-bank lenders. As all the federal regulators have noted, one of the critical issues we need to address is the fact that neither the Nontraditional Mortgage Guidance, nor the proposed Subprime Guidance applies to non-bank lenders. To address this problem, and to provide important protections, we urge the Board to use its authority under HOEPA to take, at a minimum, the following steps:

1. Require all mortgage originators to evaluate a borrower's ability to repay prior to making a mortgage loan. The Board should create a presumption that a loan that requires a borrower to pay more than 50 percent of his or her income to cover the cost of principal, interest, taxes, and insurance is not a sustainable loan and fails to meet this test.

   In both the Nontraditional Mortgage Guidance and the proposed guidance on subprime adjustable rate mortgages (ARMs), the federal regulators re-establish the prudent lending principle that no loan should be made where the borrower cannot demonstrate the ability to repay the loan, taking into account the fully indexed, fully amortizing rate, and taking into account any potential negative amortization. Lenders have testified that the payments on some of the exotic and subprime mortgages they have made will spike so high as to require borrowers to pay 60 percent to 70 percent of the borrowers' incomes. These are unsustainable loans that put borrowers in a terrible position of having to refinance at great cost, sell their homes, or default. The Federal Reserve Board and other federal regulatory agencies have correctly determined that these kinds of loans should not be made. It is particularly distressing that the vast majority of subprime loans – about 90 percent – have been made to people who already own their own homes, thereby putting those homes at risk. In fact, a study just released by the Center for Responsible Lending indicates that subprime lending has led to a net loss in homeownership in recent years.

It has been repeatedly emphasized by lenders, consumer groups, and regulators at the hearings chaired last year by Senators Allard and Bunning, as well as the two hearings held this year, that uniform standards for federally-chartered and state-chartered lenders, as well as for brokers, are highly desirable. The Board can ensure this consistent and uniform standard by, at a minimum, using its authority under HOEPA to establish that any loan that is not originated consistent with the basic, common-sense lending standards established in the Nontraditional and Subprime ARM Guidance is unfair or deceptive.

2. Designate that the failure to escrow taxes and insurance as an unfair and deceptive practice.

It is our understanding that the majority of subprime loans do not include escrows for taxes and insurance, whereas such escrows are nearly universal for prime mortgages. No analysis of a person's ability to repay a mortgage is complete without including the costs of taxes and insurance. It is quite clear from testimony received by the Committee that the failure to escrow for taxes and insurance is another practice that puts homeowners at risk. Indeed, subprime lenders and brokers seem to routinely quote monthly payments to prospective borrowers that do not include taxes and insurance as a way of deceiving the borrowers into thinking their monthly obligations will be lower than their true costs. This is clearly a deceptive practice.

3. Restrict the use of low- and no-documentation loans.

As many as 45% of subprime loans in recent years have been originated as so-called low- or no-doc loans, despite the fact that, in many cases, borrowers are willing and able to document their income. Often it appears that brokers and lenders simply qualify borrowers for these higher rate products because it is quicker and easier to do so, and leads to higher compensation for the originator. Unfortunately, this approach often results in borrowers being sold adjustable rate mortgages with higher rates when they might have qualified for 30-year fixed rate mortgages *with lower interest rates*. This puts these borrowers in unnecessary jeopardy. The Board should consider ways to greatly reduce the reliance on these loans.

While this is not a comprehensive list, quick action on these items by the Federal Reserve Board under its HOEPA authority would be extremely helpful in extending important consumer protections to homeowners and buyers. Moreover, it would do so in a comprehensive way by requiring that all lenders operate under the same rules.

Federal Reserve Board staff have indicated that the Board is undertaking a review of these issues. We appreciate that this is the first such review since you have become the Chairman of the Federal Reserve Board. We appreciate your receptivity and open mindedness in reviewing the urgent need for rulemaking to address abuses in the subprime mortgage market. Thank you for consideration of this request, and we look forward to your response.

Sincerely,

Chris Dodd
Senator Christopher J. Dodd

Jack Reed
Senator Jack Reed

Chuck Schumer
Senator Charles E. Schumer

Evan Bayh
Senator Evan Bayh

Tom Carper
Senator Thomas R. Carper

Robert Menendez
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Daniel K. Akaka
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Senator Sherrod Brown

Bob Casey, Jr.
Senator Robert P. Casey

Jon Tester
Senator Jon Tester